Securities Industry Trends

AN ANALYSIS OF EMERGING TRENDS IN THE SECURITIES INDUSTRY
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REPORT ON THE STATE OF THE SECURITIES INDUSTRY

(Address by Adrian L. Banky and Jeffrey M. Schaefer
before the SIA Annual Convention, December 3, 1987)

Our purpose will be to take a look at how our industry is doing. For the most part, we'll be examining 1987 in the context of how the securities industry has fared throughout the 1980s.

Since we'll be covering a lot of ground, we've put together some visuals that will help us zero in on the most significant trends and results. These exhibits treat such aspects as:

- The investment climate during the 1980s.
- The growth of the business.
- Revenues, costs and profitability.
- Retail and investment banking activity.
- Foreign participation in our markets.
- And, we'll also take a look at some of the impacts of the October 19 period--including sharing with you the results of a just completed mini survey on what firms are doing to stimulate business and to cut costs.

Since the exhibits contain a lot of information, we will focus on the most significant elements of each exhibit.

First, to provide a frame of reference, let's take a look at the general climate in which you have been operating.

(Exhibit 1) Our first graph depicts average daily share volume on listed and NASDAQ markets from 1981 through this October. The key point here, which comes across dramatically on the graph, is that over the past six years growth in secondary market trading of equities has been, in a word, spectacular. For the period shown, the rate of growth in volume works out to about 28%. That is, indeed, truly spectacular.

(Exhibit 2) Now let's look at stock prices during this same period. Here you see the S&P 500 index. If we assume we'll end the year above 242--and we're at 229 on December 7--that will mean two things. First, for the period 1981 through 1987, stock prices at year end will have increased each year over the prior year. Second, the compounded average rate of increase over the six years will come in at 13%. The key point we want to make here is that during the 1980s, and even with the October break, we have enjoyed very healthy increases in stock prices.

Now, given the fact we have had spectacular growth in trading volume and healthy increases in stock prices, let's look at what's been happening within our industry per se. (Exhibit 3) No surprise, seat prices on the NYSE have escalated sharply, reaching an all-time high of $1,150,000 earlier this year. Even using the $700,000 at which a seat recently traded, that represents a 146% increase over the $285,000 high of 1981.

(Exhibit 4) Here's another manifestation of good times. This next graph shows the sharp growth in the number of people employed in our industry. As you can see, we have experienced an unbroken pattern of increases in employment each year since 1981, reaching 451,000 at the end of August. The key point here is this: we've added a tremendous number of people during the 1980s. That means greatly increased manpower to cope with periods of high activity...and, of course, it also means greatly increased payrolls that work against us in periods of reduced activity.

Because personnel costs are so important, let's look at another slide that really dramatizes the growth in our work force. (Exhibit 5) Here we see how the percentage growth in our industry's employment over the past five years compares with that of other sectors of financial services. In short, there is no comparison. Our 64% growth dwarfs that of the banking and insurance industries. It is substantially greater than in real estate and consumer credit. And, it is four times greater than the 16% growth in the non-agricultural segment of our economy. Again, the key point here is a huge increase--at least up to about six weeks ago--in the most important asset, and the most important expense element, within the business--its people.

Accompanying the growth in the industry during the 1980s in total revenues, have been dramatic changes in the relative importance of different revenue sources. (Exhibit 6) One of the most important changes has been in trading profits and investment accounts--the top line on the graph. Trading and investment revenues used to be a fairly minor component of total revenue. But in the 1970s these revenues grew in importance to where, during the 1980s, they have ranged from

24% to 29% of all revenues. A second major change has been the decline in importance of commissions--shown as the line in the middle of this exhibit. This trend also started in the mid-1970s and continued into the 1980s. The bottom line on the slide tracks "revenues related to the securities business"--which grew dramatically. It includes for the most part M&A fees, private placement fees, and interest from repurchase agreements. Probably the biggest implication of these changes is that the volatility of trading profits and investment accounts has increased the volatility of both revenues and profits in the securities industry.

(Exhibit 7) On this graph, we see that despite some very profitable years, profit margins have been deteriorating through the 1980s. Look at the bars representing the total industry. Whereas pre-tax profit margins averaged 12% from 1981 through 1983, margins have declined to under 9% from 1984-3Q 1987. This declining trend in pre-tax profit margins is true across all firm categories -- National Full Line firms, Large Investment Banking firms, and Regional firms. Even the Large Investment Banks, who were the most profitable segment of the industry, have felt the deterioration. The key point here is, despite the seemingly good years we have enjoyed, margins have been shrinking throughout our industry.

(Exhibit 8) Moving away from profit margins, this exhibit shows a similar deterioration in pre-tax return on equity through the 1980s. The bars representing the total industry show that whereas industry pre-tax ROEs averaged 38% from 1981 through 1983, pre-tax ROE declined to about 23% from 1984 through 1987. If the year 1984 is ignored, the downward trend of steadily declining ROEs generally holds across all firm categories from the early 1980s to date. Again, even the Large Investment Banks experienced this deterioration despite being the most profitable segment of the industry until 1987.

(Exhibit 9) This exhibit shows that the dramatic decline in ROEs occurred at the same time industry equity capital was increasing impressively. Equity capital increased from $7 billion in 1981 to $26 billion by the third quarter of 1987; the increase has been particularly noticeable since 1985 as many brokerage firms went public or otherwise obtained additional capital. The key point is this: As capital has expanded, the industry has had to assume more risk and work harder and harder to generate the same level of returns as in earlier years--and it has failed to do so. Nevertheless--and this is important--for most of the 1980s, the securities industry has outperformed most of American industry in general. Any comparison would show that the securities industry has been among the most profitable segments of American industry.

Having just seen the deterioration in industry profitability, let's look at our industry's expense structure to see if we can find some linkages to the bottom line. (Exhibit 10) Shown here are our industry's two biggest expense elements. The top line is compensation. The lower line is interest expense. Both elements are expressed as a percent of total revenues. In combination, they account for about two-thirds of all expenses. So, these are the biggies. There are three key points for your attention. First, look at how compensation has edged upward through the 1980s: from 32% to 38%. The point here is that people costs have become a much more important factor in your expense structure...and in your profitability. Next look at the volatility in interest expense. For example, look at 1983 and 1984...and you see interest costs rocketed from 21% of revenues in 1983 to 31% in 1984. The key point here, which could have some [illegible] implications for the future, is that interest costs can be absolutely brutal during periods when activity softens and interest rates trend upward. This is something you will want to watch very closely. The third point concerns how dramatically compensation and interest costs impact profitability. As we saw just a bit ago, our most profitable year was 1982. No coincidence, compensation and interest costs were the most favorable that year, representing just 58% of revenues. In sharp contrast to that 58%, these two elements came in at 67% for the first three quarters of this year. The key point here is if you want to do something significant on expenses, you really need to look hard at compensation and interest. To lean on the cliche, "that's where the money is."

While we're on the subject of costs, let's now look at the results of a mini survey we conducted about fifteen days ago to get a flavor of what firms are doing to address cost concerns. We talked to 15 firms, representing a variety of sizes, types and locations. (Exhibit 11) As you can see:

- Four indicated that thus far they had made no real changes.
- Four others had recently made some selective cuts.
- Three had gone much farther, having made fairly widespread, significant cuts.
- And, four said they had instituted major, sweeping cuts throughout their firms.

Assuming these 15 firms are generally representative, the key point here is that cost cutting has become the order of the day--with about half the firms having already instituted significant or major reductions. If anything, that trend has intensified in the last ten days.

What sorts of cost reductions are firms making? (Exhibit 12) Here's a list drawn from the 15 firms we surveyed. As you can see, a lot of attention is being given to people costs, including:

- o Layoffs
- o Not replacing those who depart
- o Freezes on new hires
- o Salary increases
- o Rethinking of bonuses and sales comp.
- o Some terminations of non-productive RRs
- o And, restrictions on overtime

But, various other kinds of cost reductions are being implemented, including such old favorites from yesteryear as travel, entertainment, publications and so on.

(Exhibit 13) Let's turn our attention to underwriting activity. As you can see from this exhibit, total issuance of new securities has been subject to cyclical swings, particularly in the municipal sector, which explains a lot of what is going on recently in terms of cutbacks in this area of the business. The municipal sector exploded in growth in 1985, with about $243 billion in municipal securities floated. This compares with a mere $77 billion through the first three quarters of 1987. Much of this has to do with the Tax Act of 1986, which restricted many of the activities that had previously been financed through the issuance of municipal securities. The IPO market has never really recovered from 1983, except possibly for 1986, while corporate bond issuance will probably about equal that for last year. The important point is that the total amount of securities offered in 1987 will be less than 1986 and might even be less than that of 1985.

(Exhibit 14) Here we see a graphic illustration of the growing importance of the foreign investor to U.S. securities markets. Foreign holdings have soared from $233 billion in 1981 to $651 billion, an increase of almost 280%. Most of this increase was in Treasuries as well as corporate and Yankee bonds. More recently, however, there has been a dramatic increase in foreign holdings of equities as stock prices rose and as foreign investors were increasingly attracted to this investment vehicle in recent years. Naturally, all these numbers are subject to change with the recent market crash, but it will not change the basic trend of increased foreign holdings of U.S. securities over time. Furthermore, preliminary data indicate foreigners remained net buyers of stock in October, although their enthusiasm waned somewhat. The main point, though, is simply this: Foreign money has become very important to our markets.

(Exhibit 15) This graph zeroes in on the importance of foreign investors to the equities part of our U.S. markets. This exhibit compares the gross issuance of new equity offerings to the net purchases of U.S. stocks by foreign investors. In 1986 and 1987, foreign investors' net purchases have surged to over $18 billion per year and are major factors relative to the

gross offerings of new equities in the U.S. market. Given the redemptions of equity by corporations in terms of corporate buybacks, debt-for-equity swaps, etc., there are less equities outstanding today than there were several years ago. In effect, there has been a surge in foreign buying while the supply of U.S. stocks has dwindled in recent years. Thus, the key point is that foreign purchases of U.S. equities have become an even more significant factor both in the U.S. equities market and in terms of their impact on U.S. equity prices.

Let's now turn to the retail side of the business. (Exhibit 16) This next chart is both interesting and somewhat surprising. What it does is track average retail RR production from 1980. The top line gives the mean; the lower line, the median. First, let's look at our estimates for the full year 1987--shown at the right. The large national firms will average about $265,000 this year and the regionals about $185,000. In turn, we project an industry-wide average of $240,000--which is not much different from last year. You may wish to compare those numbers with your own. The second point to which we direct your attention is the somewhat surprising one. Note that mean production has risen from $146,000 to an estimated $240,000 this year. That seems like quite a rise, but it actually works out to an annual increase of only 7%. The 7% is no doubt influenced by a lot of new RRs coming into production. But even so, the 7% growth in productivity strikes us as not terribly satisfactory when one considers that the period we're looking at was outstanding in both volume and prices, and when we then further factor in the huge investments made in sales-support costs to increase broker productivity. The key point, then, is this: Increases in retail broker productivity do not seem to compare very favorably with increases in production-related costs. This is something that deserves to be looked at closely.

What about the here and now? As we all know, retail activity in just a few weeks has swung sharply from very heavy to very light. At a recent meeting of SIA's Sales and Marketing Committee we asked what firms are doing to stimulate their sales forces. (Exhibit 17) Shown in this exhibit are just a few of the approaches noted.

- Some are having virtually every broker call virtually every account--to discuss portfolios, the outlook, investment ideas and so on.

- Some are calling those customers who are nearing possible margin calls. This provides the opportunity to explore portfolio shifts or additional cash. And, it reduces the chances of having to implement margin calls later.

- Year-end tax-oriented programs are a focus in many firms.
- Some are letting their brokers know how much business they need to do between now and year end to move up on the grid.
- The use of investment managers.
- Daily sales ideas for newer brokers who haven't experienced this kind of market before.
- New advertising and sales promo campaigns have been launched by some.
- A few firms noted they are making sure their RRs are not distracted or facing financial problems as a result of their own investments.
- And, new accounts campaigns were mentioned by several.

(Exhibit 18) This exhibit dramatizes the impact of October on the world's securities markets. In effect, capitalization on the New York Stock Exchange plunged from $2.9 trillion to about $2.3 trillion in that one month alone. Although other countries had significant drops as this shock was felt throughout the world, the declines in Tokyo and other industrialized countries nowhere matched that on the NYSE. This was somewhat surprising because many experts anticipated that if stock markets were overvalued, the beginning of the trouble would originate from Japan, where many believed that market was the most overpriced of all!

(Exhibit 19) To put the market decline in perspective, it is interesting to compare the drop in the NYSE with the capitalization of other stock markets throughout the world. As this exhibit shows, the $617 billion decline on the NYSE alone was equal to the combined market capitalizations of the German, Canadian and French stock markets as of the end of September, and just trailed slightly the total market capitalization of the U.K. market! To emphasize this point, just the decline in market capitalization on the NYSE during October was almost equal to the total market capitalization of three major OECD countries and almost equal to the market cap in the U.K., which is the third largest stock market in the world.

(Exhibit 20) Much has been said about the institutionalization of the marketplace over time. This graph shows that from 1965 through the second quarter of 1987, individual holdings of equity (excluding mutual funds) have declined in relative importance from 84% to 62%. Meanwhile, institutional holdings have grown from 16% to 38% of direct ownership. However, individuals still own the major percentage of shares in the United States. This is of course different from trading

activity, which is dominated by institutions who do the bulk of trading on the NYSE. If mutual funds were included, the numbers would change somewhat in that individual holdings would be somewhat higher and institutional holdings somewhat smaller in relative importance. Nevertheless, the main point here is that the underlying trend is toward further increases in the institutionalization of the marketplace.

(Exhibit 21) This exhibit provides some light on the October break in stock prices. Institutions were heavy net buyers of stock on the NYSE to the tune of 5.8 million shares daily during the first quarter. They turned to slight net sellers in the second quarter, but returned to a net buying pattern in the third quarter. However, their sentiment started to change in September as they became net sellers of about 300,000 shares daily. This selling pressure intensified sharply in October, when their net sales averaged 4.4 million shares per day on the NYSE. Given that the average price on the NYSE droppped to about $36 per share in October, this meant that institutional selling pressure was amounting to about $160 million daily during October.

In sharp contrast, the retail sector, including corporate repurchase programs, were heavy net buyers of stock during October. From a net selling posture in the first quarter, they became net buyers in the second quarter, net sellers in the third quarter, and were net buyers of 6.4 million shares daily during October. It is clear that the change in sentiment by institutional investors starting in September and accelerating in October played a major factor in the market crash of October.

Despite this grim picture, let's see if we can conclude on a brighter note.

Actually there are several points that we feel are encouraging and auger well for the future. First, we are not terribly pessimistic about the economic outlook. With some constructive steps in Washington, the coming year could prove quite a bit better than some of the doomsayers have predicted.

Second, despite our youthful appearance, we have been around for more than just a few market cycles. In our opinion, the firms in our industry have never responded more quickly to reduce costs than you have in the past six weeks. Painful as that process is, the prompt action on costs is a clear plus. By the same token, many of your firms are vigorously addressing the retail slowdown. That too, is a plus.

Third, as noted earlier, despite the deterioration in both margins and ROE, our industry throughout the 1980s has been among the most profitable segments of U.S. business and industry.

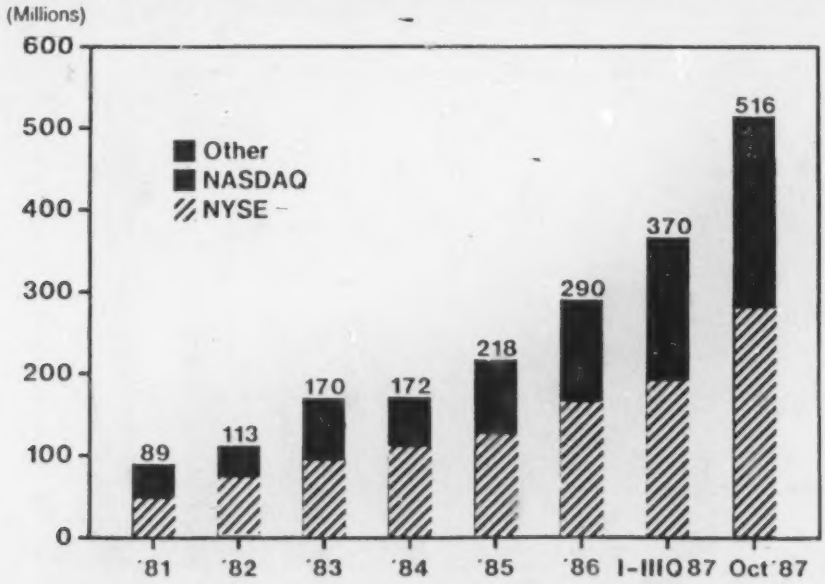
And last, there is a great deal of strategic analysis and decision making going on throughout our industry. It seems to us that when you combine strategic reappraisal with the impressive creativity and flexibility that has long characterized the people in our business, good things will result. We not only hope but believe that will be the case in the period ahead.

Adrian L. Banky
Executive Vice President and
General Manager

Jeffrey M. Schaefer
Senior Vice President and
Director of Research

1

Growth in Average Daily Share Volume



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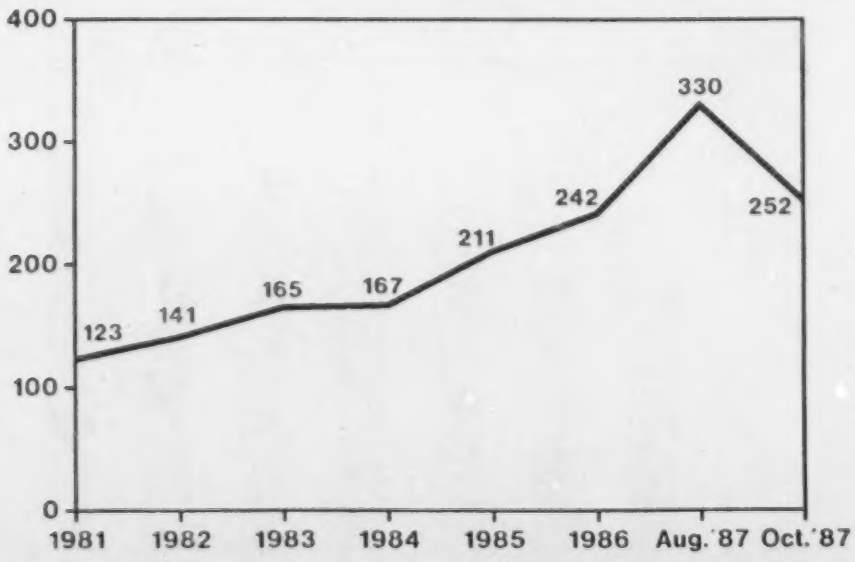
S&P 500



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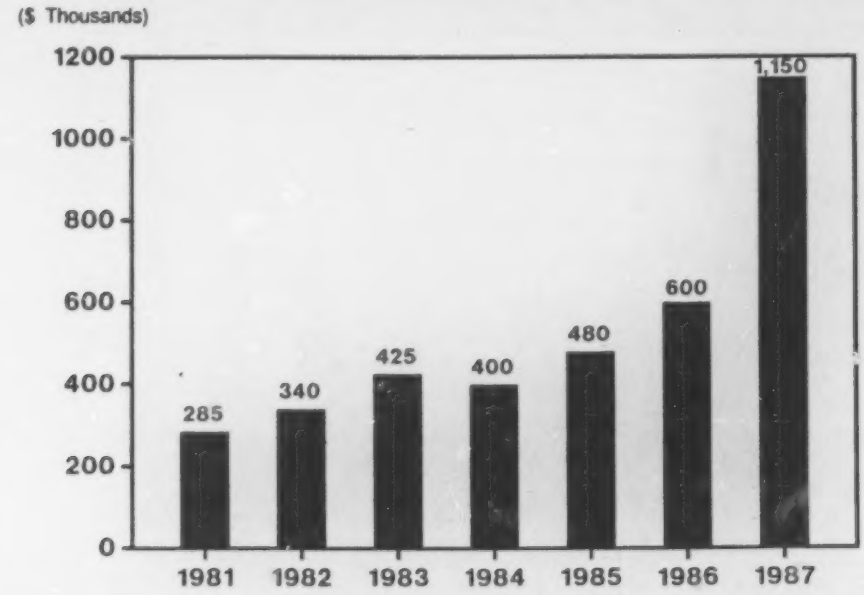
The Price of Membership on the NYSE in 1987 Was Nearly Double 1986's Record



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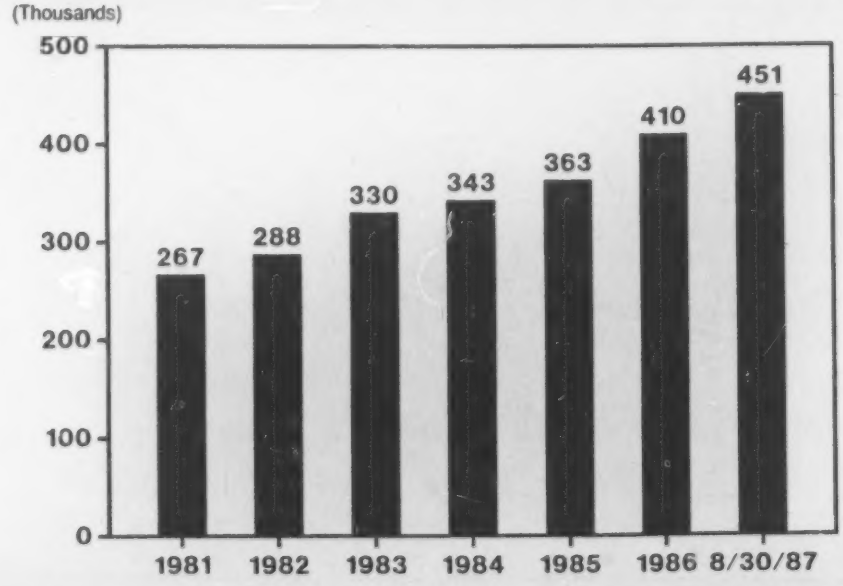
Growth in Securities Industry Personnel



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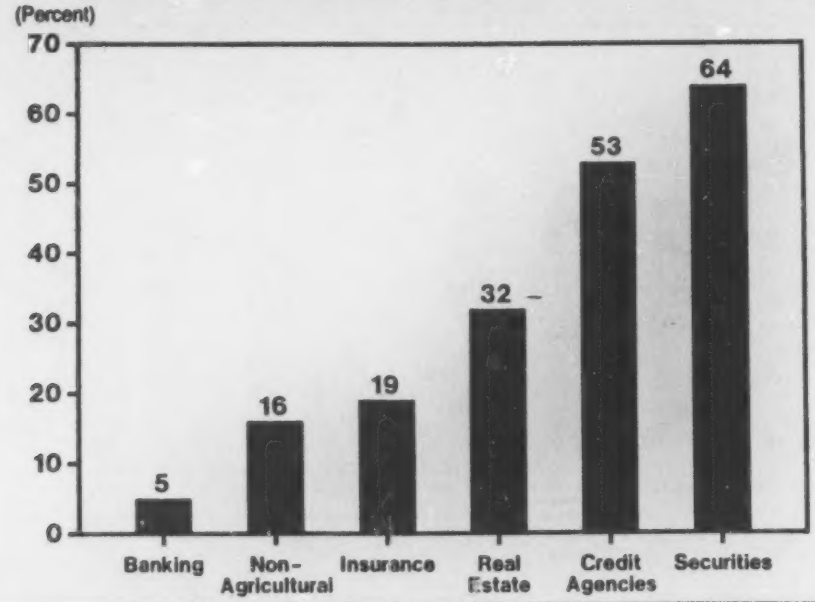
Growth in the Financial Services Sector Employment, 9/82 - 9/87



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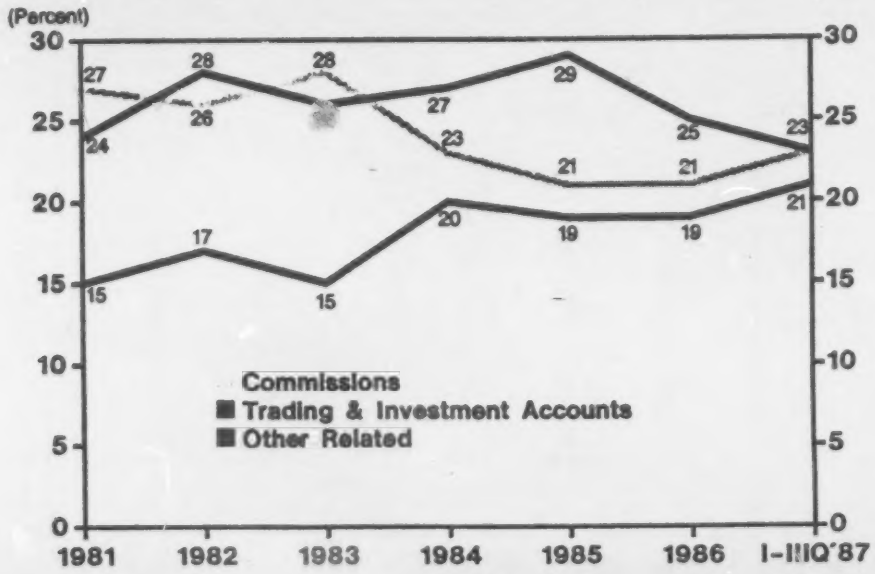
Main Components of Securities Industry Revenues



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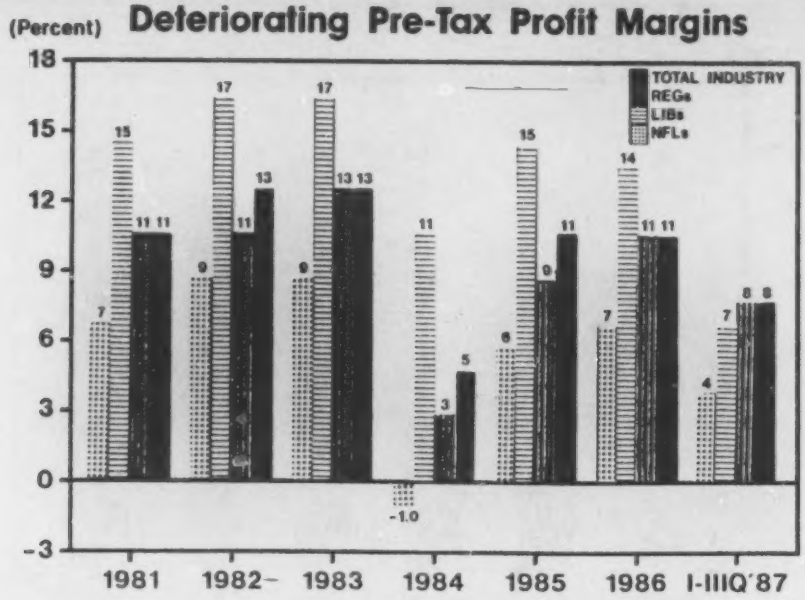
Whither Securities Industry Profitability?



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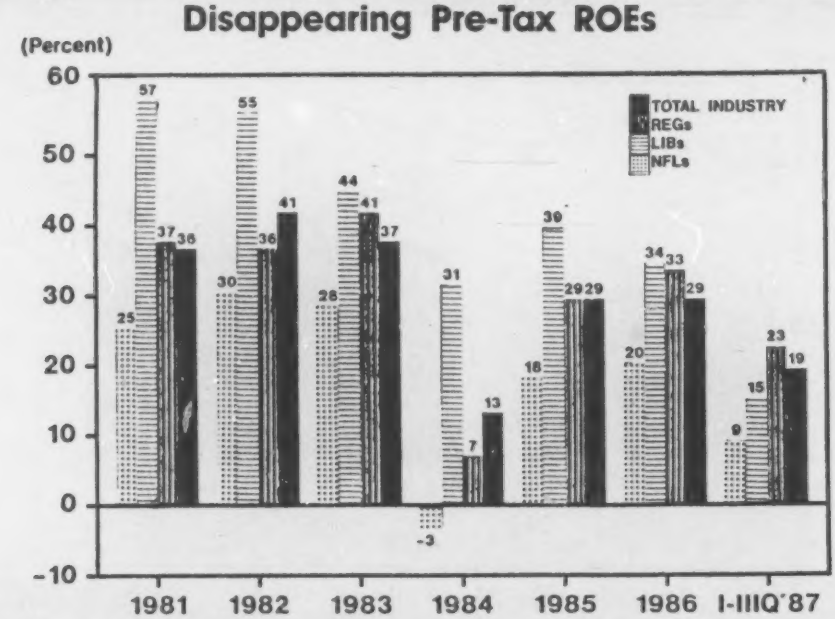
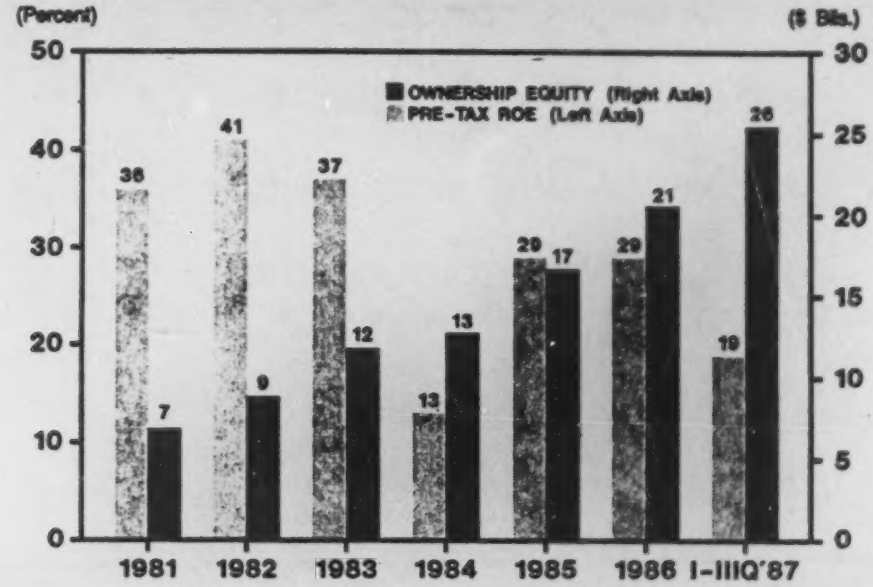
Whither Securities Industry Profitability?



9

Ownership Equity Grows While Profitability Deteriorates



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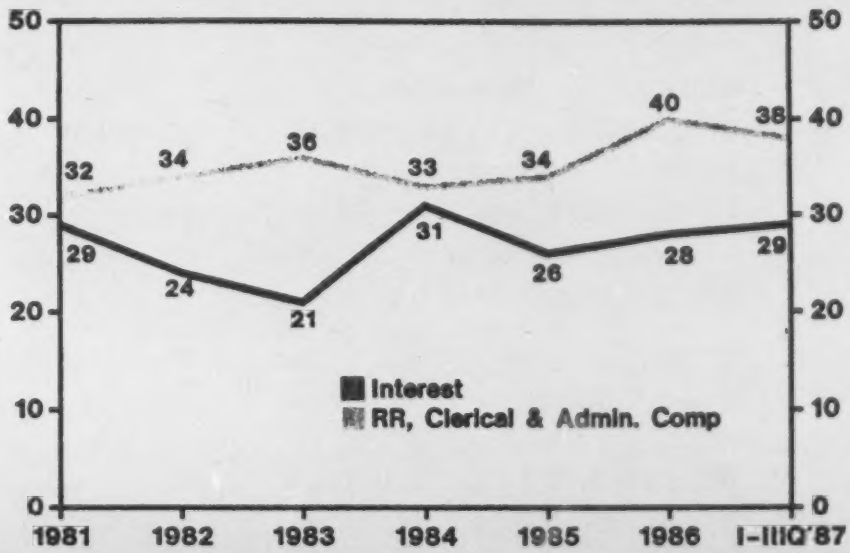
Main Components of Securities Industry Expenses



11

Cost Cutting Postures at 15 Randomly Selected Firms

4 No Real Change

4 Some Selective Cuts

3 Fairly Widespread, Significant Cuts

4 Major, Widespread Cuts

12

Types of Cost Reductions

Manpower

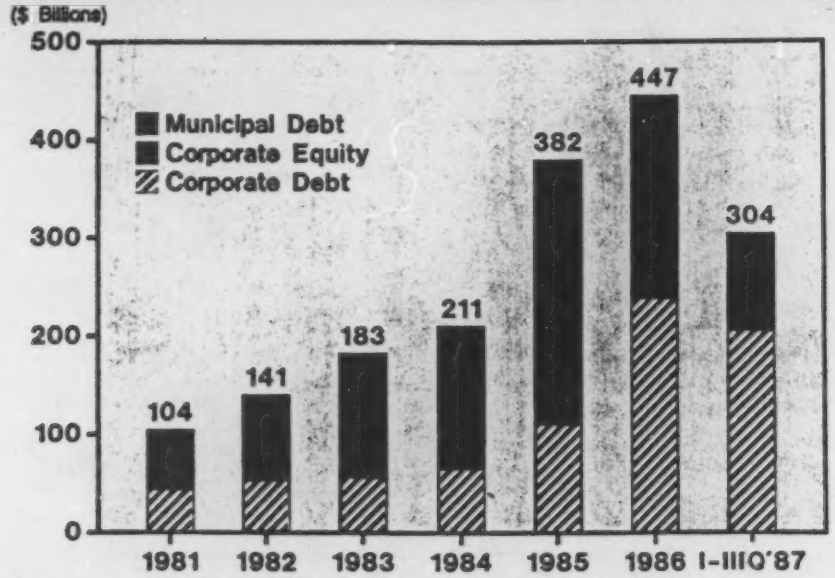
- Layoffs
- Attrition Not Replaced
- Freeze on New Hires
- Freeze/New Controls on Salary Increases
- Bonus Changes
- Sales Compensation Re-Analyses
- Termination of Low End RRs
- Ban/Controls on Overtime

Other

- T&E Controls
- Publications
- Quote Machines/Communications
- New Purchases

13

Corporate and Municipal Financing



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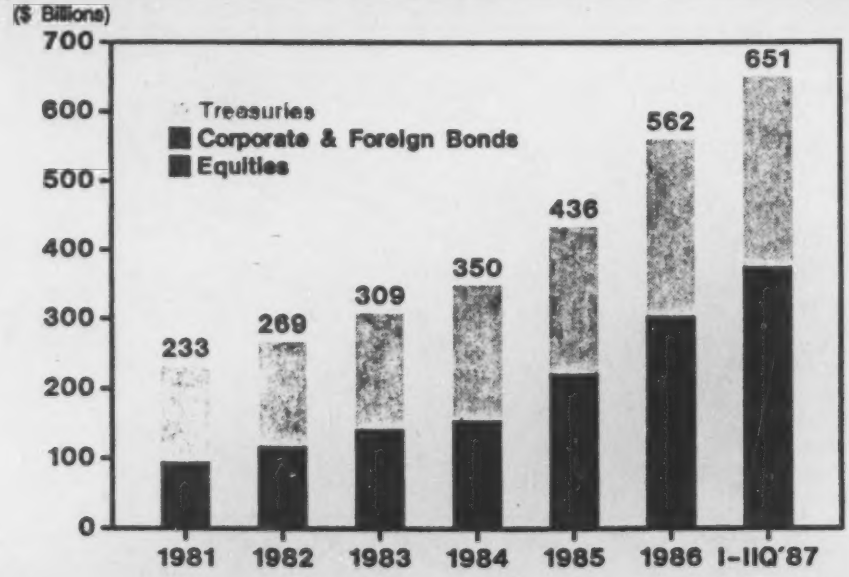
Foreign Investor Holdings of U.S. Securities



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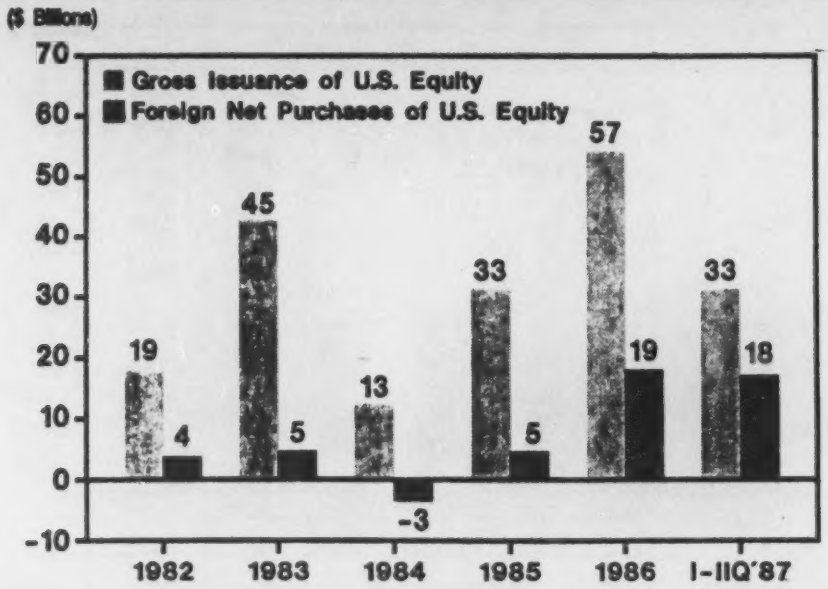
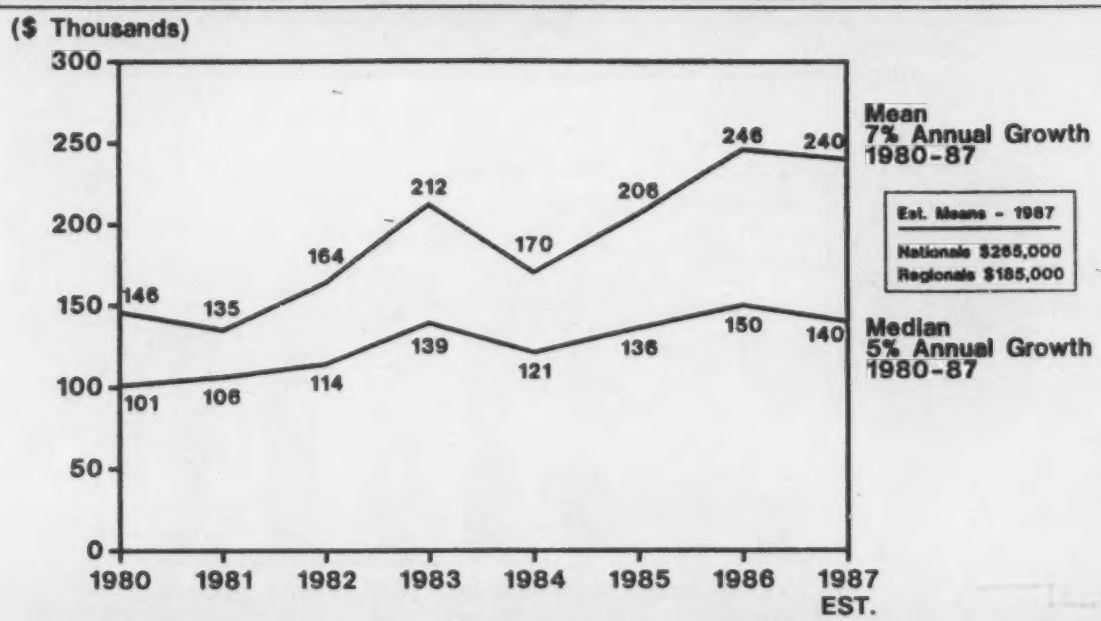
Foreign Investors Make Their Presence Felt in the U.S. Equity Markets



16

Gross Production -- Retail RRs



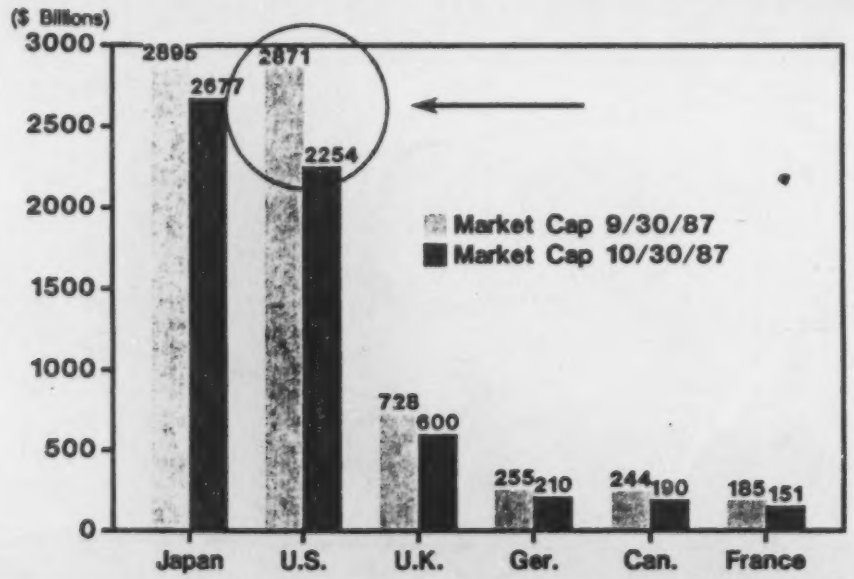
17

Steps to Stimulate Retail Sales Forces

- Call Every Account
- Call Accounts Near Margin Calls
- Encourage Tax Switches
- Tell RRs Production Needed for Payout Bonuses 1987
- Promote Use of Investment Managers
- Daily Sales Ideas for Newer RRs
- New Ad and Sales Promotion Campaigns
- Counseling RRs on Personal Financial Problems
- New Account Contests

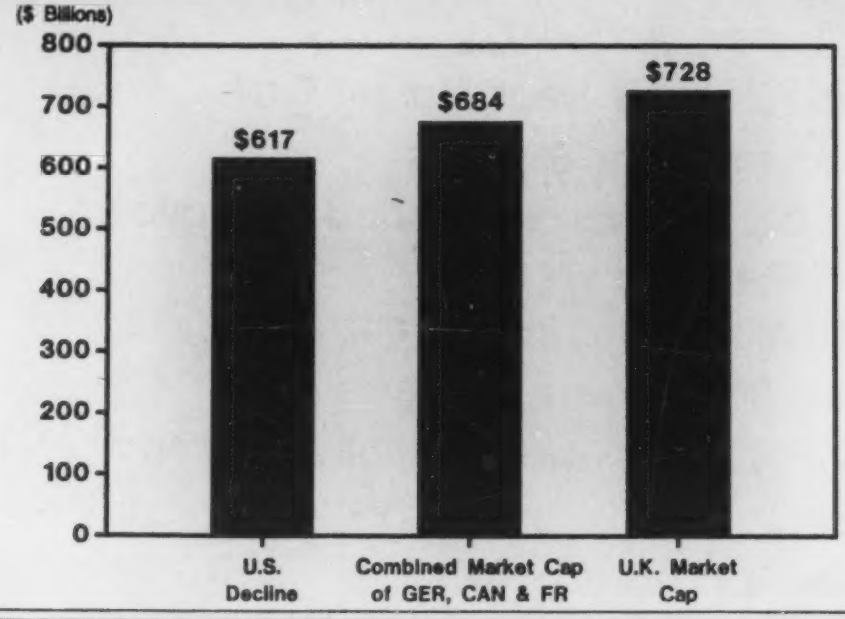
18

Market Capitalization of Major Exchanges



19

The October Decline in Perspective



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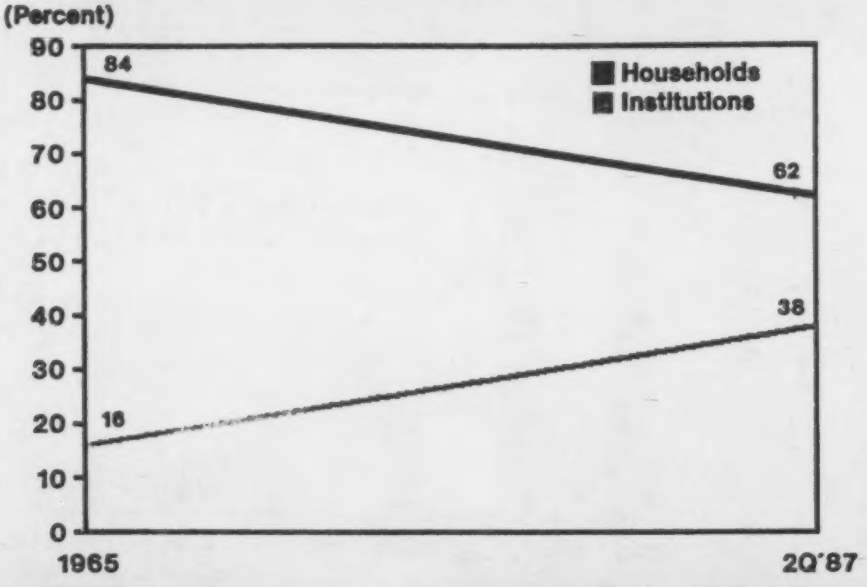
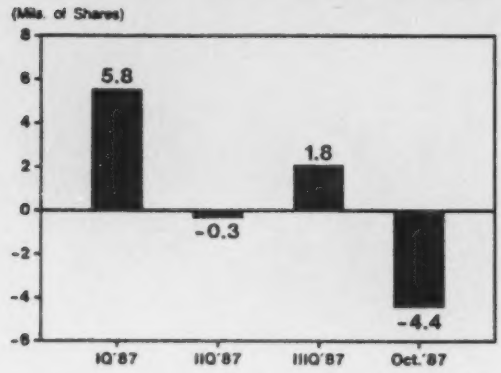
Direct Holdings of Equities



Professional Institutions

NYSE Average Daily Net Purchases



Retail Investors

NYSE Average Daily Net Purchases